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Supreme Court of the United States.

OCTOBER TERM, 1937.

No. 6.

D. W. McEACHERN, Administrator of the Estate of S. C. McEACHERN, Deceased,

PETITIONER,

v.

J. T. ROSE, Former Collector of Internal Revenue for the District of Georgia.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

BRIEF FOR PETITIONER.

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BRIEF FOR PETITIONER.

OPINION BELOW.

There was no opinion by the District Court. The opinion of the Circuit Court of Appeals is reported at 86 F. (2d) 231, and will be found at page 57 of the Record.

JURISDICTION.

The judgment of the Circuit Court of Appeals was entered on November 9, 1936 (R. 62). On February 1, 1937, the Honorable Benjamin N. Cardozo entered an order of this Court extending the time for filing a petition for certiorari in the case at bar to and including February 24, 1937 (R. 67). The petition for a writ of certiorari was filed February 23, 1937, and was granted April 5, 1937 (R. 67). The jurisdiction of this Court rests on Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED.

Whether petitioner is precluded, by reason of an alleged barred income tax liability for 1928, from recovering overpayments of income taxes for 1929, 1930 and 1931; and whether Section 44(d) of the Revenue Act of 1928, under which the alleged barred income tax liability for 1928 arises, is constitutional as applied in this case.

STATUTES INVOLVED.

The statutes involved are set forth in Appendix A.

STATEMENT.

The petitioner, as administrator of the estate of S. C. McEachern, deceased, brought this suit seeking recovery of amounts by which McEachern's estate overpaid its Federal income taxes for the years 1929, 1930 and 1931 (R. 1-13). The respondent did not deny that such taxes had

been overpaid, but asserted for defense that petitioner was estopped from recovering such overpayments by reason of the fact that certain income tax due for the year 1928 in an amount not specified remained unpaid, collection of the 1928 tax being barred by the statute of limitations (R. 15-24). The overpayments of tax for 1929, 1930 and 1931, and the alleged underpayment of tax for 1928, arose as follows:

In 1924 the petitioner's intestate, hereinafter called the "decedent," sold 500 shares of stock in the Industrial Life & Health Insurance Company for a total consideration of $300,000.00, payable $30,000.00 in cash at the time of said sale, and the balance in quarterly installments of $7,500.00 each (R. 3, 15).

As permitted by law, the decedent elected, in returning his profit from the sale for Federal income tax, to return such profit on the installment basis. The decedent died on December 12, 1928, at which time $150,000.00 of the purchase price remained unpaid (R. 3, 15).

In 1929, 1930 and 1931 the decedent's estate collected a part of the aforesaid installment obligations of $150,000.00, which had remained unpaid at decedent's death (R. 3, 15; 6, 18; 11, 21). It is not disputed that such collections constituted income to the decedent's estate only to the extent that such collections exceeded the value of the installment obligations at the date of decedent's death, this result following from the fact that upon decedent's death such installment obligations became capital assets in the hands of the decedent's estate at their then value. However, in the returns filed for the decedent's estate for 1929, 1930 and 1931 (R. 29, 33, 36), the petitioner erroneously reported the income from such collections on the same basis on which the decedent would have been required to

report the same if he had continued to live, and as a result the petitioner erroneously reported for 1929, 1930 and 1931 an excessive amount of income. The excessive income thus reported resulted in the overpayments of tax for 1929, 1930 and 1931, which are sought to be recovered in this suit (R. 1-13). The amount of recovery to which the petitioner is entitled is not in dispute, the only issue being whether or not the petitioner is precluded, by reason of the alleged barred tax liability for 1928, from any recovery at all.

The alleged barred tax liability for 1928 arises under Section 44(d) of the 1928 Revenue Act, set forth in the Appendix. Under Section 44(d), as construed by the Commissioner, the passing or transmission of the $150,000.00 of unpaid installment obligations from the decedent to his estate was declared to result in the receipt of income by the decedent in the year of his death. Such alleged income under Section 44(d) was not reported in the income tax return filed for the decedent for 1928.

It was admitted that the 1928 income tax return and all other returns filed by the petitioner were filed in good faith (R. 50).

The respondent contended that the petitioner was estopped, by reason of the alleged barred tax liability for 1928, from recovering the overpayments for 1929, 1930 and 1931. The only evidence which respondent offered with respect to the alleged tax for 1928 was a stipulation designated as Defendant's Exhibit A (R. 46-49), which stipulation was excluded by the trial court on the ground that the facts covered by the stipulation were irrelevant in that they undertook to establish the defense of estoppel, and even though the stipulation were admitted, estoppel would not be established (R. 55).

In answer to such contention, the petitioner contended

that there was no tax liability for 1928 for the reason that Section 44(d), under which the alleged tax for 1928 arises, is unconstitutional as applied in this case.

The petitioner contended further that, even assuming Section 44(d) was constitutional, there was still no basis for estoppel, because, among other reasons, the Commissioner of Internal Revenue had timely knowledge of all the material facts with reference to the alleged underpayment of tax for 1928, and his failure to collect the alleged tax for 1928 was in no way due to his having been misled by the petitioner. In support of this contention, the petitioner proved that on December 12, 1929, the petitioner filed a Federal estate tax return for the decedent's estate, which estate tax return disclosed the existence of the unpaid installment obligations in question, and disclosed that such obligations passed and were transmitted, upon the death of the decedent, to his estate (R. 39). The passing or transmission of these installment obligations from the decedent to his estate was the event which gave rise, under Section 44(d), to the alleged tax liability for 1928. The statute of limitations upon the collection of additional tax for 1928 did not expire until approximately fifteen months after the estate tax return was filed.[1] The estate tax return was investigated with usual care, and the Field Agent's Report thereon was made and transmitted to the Bureau of Internal Revenue in Washington on May 31, 1930 (R. 50), at which time the statute of limitations on collection of additional tax for 1928 had still over nine months to run.

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[1] The 1928 income return was filed March 12, 1929 (R. 46). Therefore the two year statute of limitations under Section 275 of the 1928 Revenue Act did not expire until March 12, 1931. The estate tax return was filed 15 months prior thereto, namely, on December 12, 1929 (R. 39).

The District Court directed a verdict and entered judgment in favor of the petitioner (R. 25, 54), holding that there was no estoppel and that it was therefore unnecessary to pass upon the constitutionality of Section 44(d). The Circuit Court of Appeals reversed the judgment of the District Court and held: (1) that Section 44(d) is constitutional, and (2) that because of the barred tax liability for 1928, the petitioner is not entitled to recover the overpayments for 1929, 1930 and 1931 (R. 57-62).

SPECIFICATION OF ERRORS.

The Circuit Court of Appeals erred:

(1) In holding that Section 44(d) of the Revenue Act of 1928 is constitutional, and in failing to hold that such section is unconstitutional under Article I, Section 2 of the Constitution and is not authorized under the Sixteenth Amendment to the Constitution, as applied in this case.

(2) In holding that the petitioner is estopped or otherwise precluded, by reason of the alleged barred tax liability for 1928, from recovering the overpayments of tax for 1929, 1930 and 1931.

(3) In failing to hold that the petitioner was entitled to recover the overpayments of taxes for 1929, 1930 and 1931.

(4) In reversing the judgment of the District Court.

SUMMARY OF ARGUMENT.

The respondent's entire defense rests upon the assertion of the alleged barred tax for 1928. The petitioner contends that there is no barred tax for 1928, for the reason that Section 44(d) of the 1928 Revenue Act, under which

such alleged tax for 1928 arises, is unconstitutional as applied in this case. Section 44(d) as applied in this case attempts to tax the decedent upon a "gain" declared to result from the transmission of property by death. Such an event cannot give rise to income within the meaning of the Sixteenth Amendment.

The petitioner contends further that even if Section 44(d) is constitutional, and even if there is therefore a barred tax for 1928, such barred tax for 1928 does not preclude the petitioner from recovering the overpayments for 1929, 1930 and 1931.

The petitioner urges first that there is no estoppel, for the reason that the person claiming the benefit of estoppel must have been ignorant of the true facts and must have been adversely affected by the acts of the person against whom the estoppel is claimed; whereas in the case at bar, the Commissioner had timely knowledge of all the material facts, as disclosed by the petitioner in the decedent's estate tax return, and was in no way misled by the petitioner with respect to the facts giving rise to the alleged tax for 1928.

The petitioner next contends that the issue of recoupment is not open for consideration in this case. A plea of recoupment must allege the existence of a claim, must state the amount of the claim, and must pray that such claim be set up to reduce or wipe out the main cause of action. None of these three essentials is found in any pleading filed by the respondent. The petitioner therefore contends that the issue of recoupment is not open.

The petitioner urges further that there are no special equities in this case which permit the respondent to defend on the ground of the alleged barred tax for 1928. It is well established that the Government may not defeat a

suit for refund of taxes simply by asserting a barred tax claim for a prior year, in the absence of equitable circumstances which in some way connect the barred tax with the refund sought in such manner as to render the refund claim inequitable. Such equitable circumstances most commonly arise in cases wherein the taxpayer has taken a certain position resulting in nonpayment of the barred tax, and has later sought to change that position by taking an inconsistent position after the statute of limitations has expired, with resulting loss to the Government of the barred tax. In the case at bar, petitioner is not seeking to undo or change any position which resulted in loss of revenue to the Government, and is not seeking to take any inconsistent position whatsoever with reference to the alleged barred tax for 1928. The petitioner seeks only to correct the error made by petitioner in overpaying its income taxes for 1929, 1930 and 1931, and that error had absolutely no connection with the Government's failure to collect the alleged barred tax for 1928. Furthermore, the facts were all timely disclosed to the Government in the estate tax return; the Government's failure to collect the alleged tax for 1928 is not excusable on the ground of adverse court decisions or otherwise, and the overpayments here sought to be recovered were, with the exception of $230.07, all paid after the statute of limitations barred collection of the alleged tax for 1928. There are therefore no special equities in this case which will permit the respondent to establish a defense based on the alleged barred tax for 1928, and such defense is nothing more than an attempt to offset the alleged tax for 1928 against the petitioner's right to a refund of the totally unrelated overpayments for 1929, 1930 and 1931. This Court has held that such offset will not be permitted.

ARGUMENT.

I.

SECTION 44(d) IS UNCONSTITUTIONAL AS APPLIED IN THE PRESENT CASE.

An essential element in the defense which the Circuit Court of Appeals upheld in this action, is an alleged income tax liability which is asserted against petitioner's intestate under Section 44(d) of the Revenue Act of 1928. Respondent contends that a tax under that section was imposed on decedent, but never paid, with respect to the transmission of certain "installment obligations" by death. Petitioner contends that Section 44(d) as applied in such a case is unconstitutional, in that it attempts to tax something which is not income under the Sixteenth Amendment. It is indisputable that if Section 44(d) is unconstitutional, respondent's defense falls. On the other hand, if Section 44(d) is valid and applicable, petitioner contends that the defense is without merit for reasons developed in the latter part of this brief.

In so far as it may pertain to the present case, Section 44(d) provides as follows:

> "If an installment obligation is * * * transmitted * * * gain or loss shall result to the extent of the difference between the basis of the obligation and * * * the fair market value of the obligation at the time of such transmission * * *. The basis of the obligation shall be the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full."

As that section has been construed by the Commissioner

(I. T. 2515, IX-1 C. B. 125), Congress has attempted by ipse dixit to make gain result to the decedent from the transmission of certain property to his Administrator by reason of death. Under that ruling,

> "The gain or loss resulting from the transmission • • • should be included in the decedent's return for the taxable year in which his death occurred."

It must be too plain for words that a decedent cannot realize *income* in any sense of the term by reason of the transfer of his property to others as a result of his death. The section is clearly invalid as attempting to tax as income something that is not income under the Sixteenth Amendment. *Eisner v. Macomber,* 252 U. S. 189.

Such a bold attempt to distort the concept of income cannot be matched, except perhaps by the attempt of a New York State Comptroller to tax the "income" resulting to a donor by reason of a gift of property that had increased in value in his hands. *People v. Wendell,* 196 App. Div. 613, 188 N. Y. Supp. 510. The idea was of course repudiated by the court, which pointed out the absurdity of attributing a gain to the donor by reason of the fact that he had given away the property and thus had lost it in toto.

Apart from Section 44(d), the limit to which the Federal Government has gone in attempting to predicate a realization of gain upon the disposition of property otherwise than by a sale, exchange or similar transaction, was reached in the case of *General Utilities & Operating Co. v. Helvering,* 296 U. S. 200. In that case the Government contended in this court that a corporation might realize gain by the distribution of property to its stockholders as a dividend in kind, where the property had increased in value in the hands of the corporation. See respondent's

brief in No. 41, October Term, 1935, pp. 13-28. In making this contention the Government recognized that Treasury officials and the congressional committees had expressed doubt as to the constitutionality of a provision requiring such a result. See brief cited, p. 18n. See also Hearings before House Ways & Means Committee on Revenue Revision, 1934, p. 150. However, the Government's argument in that case was based upon the theory that the dividend distribution under the circumstances satisfied a general legal obligation which the corporation owed to its stockholders, and no suggestion was made that income could be realized by a donor by an outright gift of property. See brief cited, pp. 22, 25.

Any further discussion of the invalidity of Section 44(d) should be unnecessary. But we anticipate that the Government will attempt to support Section 44(d) on the theory that its effect is to tax something other than what it says should be taxed. The lower Federal Courts which have upheld the section in cases like the present[2] seem to have proceeded on the assumption that Section 44(d) simply taxes the untaxed portion of a profit that could have been taxed in full in the year of the sale.[3] It will be shown that such an assumption is clearly unfounded and that Section 44(d) cannot be justified upon any such principle.

In order to make a fair presentation of the theory of the lower court cases just cited, and to show that the theory

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[2] Moore v. United States, 10 F. Supp. 143 (Ct. Cls.); Provident Trust Co. of Philadelphia v. Commissioner, 76 F. (2d) 810 (C. C. A. 3rd); Williams v. Commissioner, 79 F. (2d) 518 (C. C. A. 3rd); Lawler v. Commissioner, 78 F. (2d) 567 (C. C. A. 9th).

[3] Even if Section 44(d) could be construed as doing this, it would impose a new tax in 1928 with respect to a sale in 1924. Under such circumstances, the tax should clearly be held unreasonably retroactive, and therefore contrary to the due process clause of the Fifth Amendment. Cf. United States v. Hudson, 299 U. S. 498.

cannot be sustained, it will be well to discuss briefly the installment sales provisions in general, and the legislative history and purpose of Section 44(d).

Beginning with the Revenue Act of 1926, which was given retroactive application,[4] Congress has provided that the installment sales method of reporting the profit on a sale of property involving deferred payments may be employed at the election of the seller, where the initial payment does not exceed a certain percentage of the entire purchase price.[5] By electing that method the seller would report in each taxable year "that proportion of the installment payments actually received in that year which the total profit realized or to be realized when the payment is completed, bears to the total contract price."

Section 44(d) was written into the law in 1928 as a means of compensating for a loss of tax revenue resulting from the use, in certain circumstances, of the installment method of reporting income. Where a seller used the installment method of reporting a gain from the sale of property in his return for the year of the sale, he would show as income for that year only the proportionate part of the cash payments actually received in the year which represented gain. If, in the next year, before the receipt of any further payments, he should make a gift of the installment obligations, or if he should die, there was no provision of law prior to the 1928 Act under which he could be taxed on any part of the profit other than the proportionate part returned in the first year.

In many cases the profit actually taxed, under the in-

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[4] See Sections 212(d) and 1208 of the Revenue Act of 1926, quoted in Appendix A, infra.

[5] The percentage was 25% under Section 212(d) of the 1926 Act, 40% under Section 44(b) of the 1928 Act, and 30% under Section 44(b) of the 1934 Act.

stallment method, prior to the gift of the installment obligations, or their transmission by death, would be substantially less than the profit which could have been taxed in the year of the sale if the installment method had not been available. It was to compensate for the loss, in such circumstances, of a tax which could have been imposed in the year of sale, that Section 44(d) was enacted.[6]

However, it will be apparent from an analysis of the provisions that *Section 44(d) does NOT simply tax the untaxed balance of a profit which could have been taxed in its entirety in the year of the sale.* This should be clear from a consideration of the fact that the fair market value of installment obligations at the death of the seller, which is an essential element in a computation under Section 44(d), can have no place whatever in the measure of a profit realized by the seller upon the sale in some prior year.

The profit actually realized in the year of sale, and which could be taxed in that year, may be greater or may be less than the profit reported on the installment basis during the life of a seller who dies prior to the final payment of the purchase price. It would be mere chance or coincidence in any case if the "gain" taxable under Section 44(d) turned out to be the untaxed balance of the gain from the original sale that could have been taxed in prior years.

The amount of profit which could be taxed in its entirety in the year of a sale involving deferred payments would depend upon the nature and value of the purchase money obligations. If the deferred payments are represented by negotiable promissory notes which have a fair market

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[6] See House Rep. No. 2, 70th Cong., 1st Sess., p. 16; Senate Rep. No. 960, 70th Cong., 1st Sess., p. 24.

value, and are the equivalent of cash to that extent, the seller realizes by the sale a profit measured by the excess of cash and fair market value of notes over the cost of the property sold. If the notes bear a reasonable rate of interest, and if they are adequately secured, their fair market value at the time of sale may equal their face amount. In such a case Congress could constitutionally tax in the year of the sale the entire profit to be realized from the transaction, with the exception of the interest payable on the purchase money notes, which would be taxable as received.

On the other hand, if the purchase money notes have a fair market value at the time of sale, of only 50% of their face amount, Congress cannot constitutionally tax the seller with the entire profit to be realized from the transaction until the notes are actually collected. If the seller reports on the installment basis in such a case and dies before the collection of all deferred payments, the profits taxed to him during life may actually exceed the profit that could have been taxed as having been realized at the time of sale, plus the profits resulting from collections as made.[7]

In a case like the present, where the deferred payments were not represented by notes or other specialties, and did not bear interest, the correct method of reporting gain on the sale, in the absence of the installment sales method, would probably be to treat the collections first as a return of the seller's capital or cost and any excess as income. G. C. M. 1387, VI-1 C. B. 48. And cf. *Burnet v. Logan*, 283 U. S. 404. In such a case, if the seller dies before the final payment, the amount taxable on the installment basis will be greater than the amount that could be taxed under

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[7] For a graphic illustration of this possibility, see Appendix B, infra.

the method approved in the General Counsel's Memorandum just cited.[8]

It is thus apparent that where a seller, who has reported on the installment period, dies prior to the final payment of the purchase price, there may or there may not be an untaxed balance of a profit which could have been taxed to the seller under some other method. *If Congress had wanted simply to collect the balance of a tax which it could have collected in some prior year, but did not, it could have expressed this purpose in so many words.* It could have provided that:

> Where installment obligations are distributed or transmitted, otherwise than by sale or exchange, and where it appears that the seller had elected to report the sale on the installment method, there should be taxed to the seller in the year of such distribution or transmission that portion of the profit actually realized upon the sale which had not been previously taxed under the installment method.

But Section 44 (d) does not attempt to do this.

As applied here, Section 44 (d) would impose a tax on the decedent with respect to a fictitious "gain" measured by the excess of the fair market value of the purchase money obligations at the seller's death over the "basis" of the obligations. "Basis" is defined as "the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obliga-

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[8] If this method were applied here, a profit of only $145,000.00 would have been taxed to decedent upon the collection of $150,000.00 during life, the entire cost of $5000.00 being applied against first collections. On the other hand, a profit of $147,500.00 was taxable to decedent under the installment method, without giving any consideration to Section 44(d).

tion satisfied in full." The definition is periphrastic, but the effect of the section is to tax in the year of death the profit that would have been realized if the obligation were collected in full, with a certain adjustment based upon the market value of the obligation at the time of the seller's death. If the market value of the obligation at the seller's death is less than the face amount, the profit that would have been realized upon the eventual collection in full should be reduced to the extent of the deficiency in market value, in order to arrive at the "adjusted profit" taxable under Section 44 (d).

It must be apparent from the foregoing that the "profit" which Section 44 (d) attempts to tax has no relation to the profit which could have been taxed in the year of sale. The profit realized by the decedent on the sale in 1924 depended in part upon the fair market value of the purchase money obligations *at that time*, if they had any such value. Whatever value the uncollected obligations had in 1928, when decedent died, has nothing to do with the gain realized in 1924.

Viewing Section 44 (d) in another light, it has the effect of taxing the unrealized appreciation in the value of the installment obligations between the date of sale and the date of death, in addition to the gain realized upon the sale. It may be granted that a seller, on a cash receipts and disbursements basis, realizes taxable gain measured by the excess of cash and market value of purchase money obligations at the time of sale over the cost of the property sold. But in the computation of "gain" under Section 44 (d) it is not the value of these obligations at the time of sale, but their value at the date of death which is controlling. The effect of Section 44 (d) is thus to tax any appreciation in the value of these obligations between

sale and death, although such appreciation is never realized.

The Circuit Court of Appeals for the Second Circuit has recognized that in so far as Section 44 (d) attempts to tax this unrealized appreciation in value, it is aimed at something which is not income under the Sixteenth Amendment. *Crane v. Helvering,* 76 F. (2d) 99. In that case Section 44 (d) was sustained as applied to a sale *after* the passage of the 1928 Act, upon a theory which will be presently discussed. However, Circuit Judge Learned Hand, writing the opinion of the court, clearly recognized that Section 44 (d) undertakes to tax something which is not income in such a case. Judge Hand said:

> "The (purchase money) debt, though secured by the property sold, may be of less value than its face when received; usually it is. If so, it is likely to increase between its receipt by the testator and his death, and section 44 (d) taxes that increase, though it is not 'realized.' Under Eisner v. Macomber, 252 U. S. 189, such an increase is not income and is beyond the power of Congress under the Sixteenth Amendment."

But notwithstanding the clear recognition of the fact that such increase in value could not be taxed as income under the Sixteenth Amendment, Section 44 (d) was there upheld as applied to a sale in 1929, which the seller elected to report on the installment method authorized by Section 44 (b) of the 1928 Act. The basis for the decision is expressed in the following language from Judge Hand's opinion:

> "The statute might have taxed at once, a gain based upon the value of the bond and mortgage, for that was 'realized' as soon as they were received * * *. Sec-

> tion 44 (b) gave the taxpayer a privilege to avoid such a tax if he wished, but affixed to it the condition that if he died, the value of the obligation should be regarded as then realized."

A similar result was reached by the Circuit Court of Appeals for the Tenth Circuit in *Nuckolls v. United States*, 76 F. (2d) 357. The Court there said:

> "Congress is not required by the constitution to extend the privilege (of reporting on the installment basis) at all, as indeed it did not prior to 1926; when it did so, it had a right to attach thereto this condition. The taxpayer is not obliged to avail himself of the privilege conferred; if he does so, he takes it with the condition attached."

The decisions in the two cases just cited are justified on the principle that Congress can tax some things that are not income, where the treatment of such items is voluntarily accepted by the taxpayer as a condition to the exercise of a privilege which Congress need not extend. Compare *Helvering v. Independent Life Insurance Co.*, 292 U. S. 371. In that case this Court recognized that the rental value of space occupied by an insurance company in its own building could not constitutionally be taxed as income under the Sixteenth Amendment, but it was held that the treatment of such an item as income could be voluntarily accepted by the taxpayer as a condition to the allowance of certain deductions which were a matter of legislative grace.

However, similar principles cannot possibly be applied in a case like the present one. Here the sale occurred in 1924, and Section 44(d) was not enacted until 1928. There was nothing in the law like Section 44(d) prior to its en-

actment. Before the 1928 Act it was clear that an installment seller could not be taxed upon the disposition of installment obligations either by gift, or by death.[10]

Petitioner cannot possibly be in the position of one who has voluntarily agreed to be taxed with respect to something that is not income, as a condition of the exercise of a privilege.

As construed by the Commissioner, Section 44(d) attempts to impose an income tax on a decedent with respect to a so-called "gain" resulting from the transmission of certain property by death. No gain within the meaning of the Sixteenth Amendment can possibly result from any such transaction, and Section 44(d) is therefore invalid. As applied in a case like the present, where the original sale was made before the enactment of Section 44(d), the Section cannot be sustained on any other theory.

II.

THERE IS NO ESTOPPEL SINCE THE COMMISSIONER HAD TIMELY KNOWLEDGE OF THE MATERIAL FACTS GIVING RISE TO THE ALLEGED TAX FOR 1928, AND WAS IN NO WAY MISLED BY THE PETITIONER WITH RESPECT THERETO.

Under Heading I above it has been shown that there is no tax due for 1928 for the reason that Section 44(d) of the 1928 Revenue Act, under which the alleged tax for 1928 arises, is unconstitutional as applied to the facts of this case. Under this Heading II and the remaining portions of this brief, it will be shown that even if Section 44(d) is constitutional, and even if there is therefore a barred tax

[10] See note 6, supra.

liability for 1928, as alleged by the respondent, such barred tax liability for 1928 does not establish any defense for the respondent in this suit. Under this Heading II it will be shown that there is no estoppel.

It is well established that the person claiming the benefit of an estoppel must have been ignorant of the true facts and must have been adversely affected by the acts of the person against whom the estoppel is claimed. It follows that there is no estoppel in this case because: (1) The material facts giving rise to the alleged tax for 1928 were all fully disclosed to the Commissioner in the estate tax return filed by the petitioner long before the statute of limitations ran on the collection of such alleged tax for 1928; and (2) the petitioner made no misrepresentations which could possibly have caused the Commissioner's failure to collect the alleged tax for 1928.

The material facts giving rise to the alleged tax for 1928 under Section 44(d) are the existence of the installment obligations in question and the passing or transmission of those installment obligations from the decedent to his estate upon the decedent's death. *These very facts which give rise to the alleged tax for 1928, namely, the existence of the installment obligations in question and the passing or transmission of those installment obligations from the decedent to his estate, were affirmatively disclosed by the petitioner in the decedent's estate tax return filed approximately 15 months before the statute of limitations ran on collection of the alleged tax for 1928* (R. 39).[11] Since the petitioner thus affirmatively disclosed all of the material facts to the Commissioner long before the statute of limitations ran on 1928, it is plain that the Commissioner's

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[11] See footnote 1 at page 5, supra.

failure to collect the alleged tax for 1928 was in no way the result of his having been misled by the petitioner.

It appears further that at no time did the petitioner make any misrepresentation which could possibly have caused the Commissioner's failure to collect the alleged tax for 1928. Acting under a mistake which the respondent admits was made innocently and in good faith (R. 50), the petitioner, in making the income tax returns for the decedent's estate for 1929, 1930 and 1931, erroneously reported a sale of 50 shares of the stock in question in each year (R. 41, 43, 44), whereas the petitioner should have reported in each year the collection of an installment on the purchase price of 500 shares of stock sold in 1924. However, the erroneous representation that 50 shares of stock were sold in each year could not possibly have led the Commissioner to reach the totally unrelated conclusion that the decedent owned no installment obligations at his death, and therefore such erroneous representation could not possibly have caused the Commissioner's failure to collect the alleged tax for 1928.

It may be pointed out further that the petitioner's erroneous treatment of these installment collections appears quite plainly on the face of the 1929, 1930 and 1931 returns as a mistake. For example, the 1929 return stated on its face that the 50 shares of stock were acquired in 1918 (R. 29); and at the same time showed on its face that the taxpayer making the return was the estate of a decedent who had died on December 12, 1928 (R. 26). The most casual investigation of this 1929 return would necessarily have disclosed the fact that some mistake had been made, since an estate which only came into existence on December 12, 1928, could not have acquired 50 shares of stock in 1918. Had the Commissioner made any effort to correct this ob-

vious error in the 1929 return, such effort would undoubtedly have led to a timely collection of the alleged tax for 1928 under Section 44(d). It is interesting to note that this error which appeared so plainly on the face of the 1929 return was obviously an error against the taxpayer's interest, which may or may not have had anything to do with the Commissioner's failure to correct it.[12]

The rule that a person claiming the benefit of an estoppel must have been ignorant of the true facts and must have been adversely affected by the acts of the person against whom the estoppel is claimed is applicable in Federal income tax cases as well as in other fields. See *Commissioner v. Union Pacific R. Co.*, 86 F. (2d) 637 (C. C. A. 2nd, 1936); *A. G. Hull v. Commissioner*, 87 F. (2d) 260 (C. C. A. 4th, 1937); *McNaghten v. United States*, 17 F. Supp. 509 (Ct. Cls., 1937).

In *Commissioner v. Union Pacific R. Co.*, supra, the taxpayer had sold property at a profit in 1917 and 1920, but had erroneously reported such sales as being taxable in 1926. After the statute of limitations had run on 1917 and 1920, the taxpayer sought to have its tax liability for 1926 determined upon a correct basis by eliminating from its 1926 income the profit which should properly have been reported in 1917 and 1920. The Circuit Court of Appeals for the Second Circuit rejected the Commissioner's plea

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[12] In the 1929 return the 50 shares were shown to have been acquired in 1918 at a cost of $500.00 and to have been sold in 1929 for $26,250.00, resulting in a profit of $25,750.00 (R. 29). A Revenue Agent examining the 1929 return would have known that the correct basis of any stock acquired from the decedent was its value on December 12, 1928, rather than its cost in 1918; and could scarcely have failed to conclude that the mistake was one against the taxpayer's interest, since it was highly improbable that the 50 shares increased in value from $500.00 to $26,250.00 during the interval between December 12, 1928, and the date of sale in 1929.

of estoppel, holding that the person claiming the benefit of estoppel must have been ignorant of the true facts and must have been adversely affected by the acts of the person against whom the estoppel is claimed; that the Commissioner had timely knowledge of all the material facts; and that there was therefore no estoppel. The Commissioner did not apply for certiorari.

In *A. G. Hull v. Commissioner,* supra, the taxpayer received a large sum as consideration for granting an option. The Commissioner sought to tax such sum as income for 1926. The taxpayer claimed that such sum was income in 1925, if at all. The Commissioner claimed estoppel on the ground that such income had not been reported by the taxpayer in 1925, and the statute of limitations had run on the collection of additional tax for 1925. The Circuit Court of Appeals for the Fourth Circuit held that there was no estoppel since the Commissioner had full knowledge of all the material facts before the statute ran. The Commissioner did not apply for certiorari.

In *McNaghten v. United States,* supra, the taxpayers sued to recover certain taxes overpaid by them for 1927. The Government sought to defend on the ground that a certain trust, of which these taxpayers were beneficiaries, had failed to pay its proper tax for 1927, the statute of limitations having run against collection of such tax from the trust. The Court of Claims rejected this defense, holding inter alia, that there was no basis for estoppel, since all the facts necessary to a determination and assessment of the taxes against the trust were fully known to the Commissioner 8½ months before the statute ran. The Government did not apply for certiorari.

In the case at bar, the Commissioner was not ignorant of the true facts and was not adversely affected by the acts

of the petitioner, but on the contrary, had timely knowledge of all the material facts as disclosed in the estate tax return, and was in no way misled by the petitioner. There is therefore no estoppel in this case.

III.

THE ISSUE OF RECOUPMENT IS NOT OPEN UNDER THE PLEADINGS IN THIS CASE.

The respondent, in opposing the granting of certiorari in this case, urged that the decision of the Circuit Court of Appeals was rested on the ground of recoupment, although the decision of the Circuit Court of Appeals does not mention the term "recoupment", and does not indicate that the Court relied in any way upon the doctrine of recoupment or any principle analogous thereto.

In its pleadings and at the trial of the case in the District Court the respondent relied solely upon the defense of estoppel. No claim of recoupment was made in the pleadings; no claim is made therein that the alleged tax for 1928 should be set off against or used to reduce or wipe out petitioner's claim for the refund of the overpayments for 1929, 1930 or 1931. The amount of the alleged underpayment of tax for 1928 is nowhere stated in the respondent's pleadings, nor is any indication therein given as to whether such amount is greater or less than the amount which petitioner sued for.

A plea of recoupment must be as definite and certain as though it were an original cause of action. See *Campbell v. Trunnell,* 67 Ga. 518; *Whitt v. Blount,* 124 Ga. 671; *Atlanta Glass Company v. Noizet,* 88 Ga. 43; *McGuire v. Gerstley,* 204 U. S. 489. Clearly the respondent's pleadings in this case fail to meet the foregoing requirements. *Of*

particular significance is the fact that nowhere do such pleadings set forth any amount sought to be recouped. The pleadings were in no way calculated to put the trial judge on notice that the respondent intended to rely upon any such defense.

The only evidence offered by petitioner or respondent at the trial of the case, which could conceivably support a defense of recoupment, is contained in the stipulation designated as defendant's Exhibit A (R. 46-49). That stipulation was offered solely in support of respondent's plea of estoppel and was rejected by the trial court on the ground that the defense of estoppel would not be established, even though the stipulation were admitted (R. 55).

The stipulation just referred to was properly excluded for the reason that it was irrelevant, in that it failed to support the defense of estoppel in connection with which it was offered. Furthermore, even if such stipulation had been offered to prove recoupment, as was not the case, such stipulation should not have been received to prove recoupment, since recoupment was not pleaded and since the evidence must conform to the pleadings. See *Garrett v. L. & N. Railroad Company,* 235 U. S. 308; *Pirkle v. Cooper,* 113 Ga. 828; *Groover v. Simmons,* 163 Ga. 778; *Louisville & Nashville R. Co. v. Barrett,* 143 Ga. 742.

The trial court therefore properly excluded the respondent's Exhibit A and there is therefore no evidence at all in the record to support any belated claim of recoupment by the respondent. Certainly the respondent cannot come in at this late date and assert a defense of recoupment on a record where no recoupment was pleaded or raised in any way in the trial court.

In any event, as is shown under Heading IV below, there is no basis for the respondent's defense based on

the alleged tax for 1928, whether that defense be called estoppel or recoupment or however it may be designated.

IV.

THERE ARE NO SPECIAL EQUITIES IN THIS CASE WHICH WILL PERMIT THE RESPONDENT TO DEFEND ON THE GROUND OF THE ALLEGED TAX FOR 1928.

It is clear that when a taxpayer sues for refund of income taxes which have been overpaid, the Government does not establish a defense by merely showing the existence of a barred tax claim against the taxpayer for some prior year, unless there are circumstances establishing some such connection between the barred tax and the refund sought, as to render the refund claim inequitable.

The most common type of case in which such equitable circumstances exist, and in which the Government may therefore defend on the ground of the barred tax, is the case where the taxpayer has taken some position resulting in non-payment of the earlier year's tax, and thereafter, when the statute of limitations has run on the collection of such earlier year's tax, has sought, by refund suit or otherwise, to take another position inconsistent with the prior position which resulted in non-payment of the earlier year's tax. In such cases where the taxpayer seeks, at the Government's expense, to take an inconsistent position with regard to the same matter, the courts have been liberal in permitting the Government to assert the barred tax claim as a defense, on the theory of estoppel, recoupment or otherwise.

No such situation exists in the case at bar. In the case

at bar, the petitioner is not seeking to change any position which resulted in loss of revenue to the Government. The only error which petitioner is seeking to correct in this case is the error innocently made by the petitioner in overpaying its taxes for 1929, 1930 and 1931, and that error had absolutely no connection whatever with the Government's failure to collect the alleged tax for 1928. The petitioner's claim that it is entitled to recover the taxes which it overpaid for 1929, 1930 and 1931 is in no way inconsistent with any position which petitioner has ever taken with respect to the alleged tax for 1928. This is not a case of there being a certain amount of income which must necessarily fall in one year or the other. The petitioner's case does not rest in any way on showing that the taxes were due in 1928 instead of in 1929, 1930 and 1931.

The alleged tax for 1928 became due, if at all, solely by reason of the decedent's death while owning the installment obligations in question, and nothing which has been done or which can now be done by the petitioner with reference to its taxes for 1929, 1930 or 1931 can possibly have any bearing whatsoever upon the question of whether or not such tax became due for 1928 under Section 44(d).

The petitioner's taxes were overpaid for 1929, 1930 and 1931 because in computing the taxable income for those years from the collection of the installment obligations in question, the petitioner erroneously used, as the basis for determining such income, the original cost of the stock to the decedent, whereas petitioner should have used, as such basis, the value of the installment obligations at the date of decedent's death—an error which has absolutely no connection whatsoever with the entirely independent question of whether any tax became due for 1928 under Section 44(d).

The situation in this case is therefore entirely different from that involved in *Stone v. White*, 301 U. S. 532, 57 S. Ct. 851, and similar cases. In *Stone v. White*, the income there in question was admittedly taxable either to the trustee or to the beneficiary. The trustee could not claim exemption from the tax on such income without conceding at the same time that such income was taxable to the beneficiary, and vice versa. In the case at bar, there is no such "either-or" relation between the overpayments for 1929, 1930 and 1931, on the one hand, and the alleged tax for 1928, on the other. Denial of the tax liability for 1929, 1930 and 1931 is in no way a concession that the alleged tax for 1928 was due. As a matter of fact, the petitioner has contended vigorously throughout each stage of this case that no tax is due for 1928 for the reasons set out under Heading I of this brief.

It follows that the Government may not assert the alleged tax for 1928 as a defense on any theory that the petitioner is seeking to take any inconsistent position at the Government's expense.

The Government is also frequently permitted to assert a barred tax claim as a defense to a refund suit in cases where the taxpayer has in some way caused the Government's failure to collect the barred tax. Under Heading II of this brief, it has been shown that the Government's failure to collect the alleged tax for 1928 under Section 44(d) was in no way caused by the petitioner, but that, on the contrary, the petitioner disclosed all of the material facts in the estate tax return long before the statute of limitations ran, and at no time made any misrepresentations to the Government with respect to the facts giving rise to such alleged tax for 1928 under Section 44(d). The respondent did not offer any evidence whatsoever to show

that the Commissioner's failure to collect the alleged tax for 1928 was in any way caused by any act of the petitioner. There is therefore no basis for allowing the respondent to assert the alleged tax for 1928 as a defense on any theory that the Government's failure to collect that tax was in any way caused by the petitioner.

In determining whether or not the Government may defend on the ground of a barred tax, consideration may be given, in a proper case, to the fact that the Government's failure to make a timely collection of the barred tax was excusable by reason of adverse court decisions, later reversed. In *Stone v. White,* supra, this Court took cognizance of the Government's inability to protect itself under such circumstance, and undoubtedly such circumstance was a moving factor in that decision. In the case at bar no excuse can be found for the Government's failure to make a timely collection of the alleged tax for 1928 under Section 44(d). The material facts giving rise to such alleged tax were all timely disclosed by the petitioner in the estate tax return, and the Commissioner was bound by no interpretation of the law, except his own, with respect to the question of applying Section 44(d). See *McNaghten v. United States,* 17 F. Supp. 509, at p. 515 (Ct. Cls., 1937), recognizing the distinction just pointed out.

In *Stone v. White,* supra, there is some intimation that the Government might be permitted to assert a barred tax claim to defeat a refund claim for a later year, if it appeared that the overpayment for the later year was made before the statute of limitations barred the collection of tax for the earlier year. In the case at bar all but $230.07 of the amount here sued for was paid *after* the statute of limitations expired on the collection of additional tax for

1928.[13] There is therefore no basis for suggesting that the overpayments here sought to be recovered (other than the $230.07 referred to above) should be applied to discharge the alleged tax for 1928, which alleged tax was already barred by the statute of limitations at the time when such overpayments (other than the $230.07 referred to above) were made.

It appears then that the petitioner is not seeking in this suit to take any inconsistent position at the Government's expense; that the petitioner is not seeking to change any position previously taken by it with reference to the alleged tax for 1928; that the Commissioner's failure to collect the alleged tax for 1928 was in no way caused by any action of the petitioner; that the material facts were all disclosed to the Commissioner in the estate tax return long before the statute of limitations ran on 1928; that the Commissioner's failure to collect the alleged tax for 1928 is not excusable in any way, since the Commissioner had timely knowledge of all the facts, and was bound by no interpretation of the law except his own; that with the exception of $230.07 all of the overpayments sought to be recovered in this suit were paid after the statute of limitations had already barred collection of the alleged tax for 1928; and that there are therefore no special equities of any sort to support the respondent's assertion of the alleged tax for 1928 as a defense. In the absence of such special equities, the respondent's defense is no more than

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[13] The decedent's 1928 income return was filed March 12, 1929 (R. 46) and the two year statute of limitations under Section 275 of the 1928 Revenue Act therefore expired on March 12, 1931. The entire overpayments for 1930 and 1931 were paid after March 12, 1931 (R. 6, 18, 10, 21); and the overpayment for 1929 alone was paid prior to March 12, 1931. The overpayment for 1929 sought to be recovered in this suit is only $230.07 (R. 2-5).

an effort to offset such alleged tax for 1928 against petitioner's right to recover the overpayments sued for. In *Stone v. White,* supra, this Court clearly indicated that the Government may not thus assert a barred tax claim by way of offset, in the absence of special equities which, as shown above, are not present in this case.

CONCLUSION.

For the reasons set forth above, it is respectfully submitted that the judgment of the Circuit Court of Appeals should be reversed, and the judgment of the District Court should be affirmed.

Respectfully submitted,

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APPENDIX A.

Revenue Act of 1926, c. 27, 44 Stat. 9.

Sec. 212(d). Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the total profit realized or to be realized when the payment is completed, bears to the total contract price. In the case (1) of a casual sale or other casual disposition of personal property for a price exceeding $1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed one-fourth of the purchase price, the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this subdivision. As used in this subdivision the term "initial payments" means the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made.

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Sec. 1208. The provisions of subdivision (d) of section 212 shall be retroactively applied in computing income under the provisions of the Revenue Act of 1916, the Revenue Act of 1917, the Revenue Act of 1918, the Revenue Act of 1921, or the Revenue Act of 1924, or any of such Acts as amended. Any tax that has been paid under such Acts prior to the enactment of this Act, if in excess of the tax imposed by such Acts as retroactively

modified by this section, shall, subject to the statutory period of limitations properly applicable thereto, be credited or refunded to the taxpayer as provided in section 284.

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Revenue Act of 1928, c. 852, 45 Stat. 791.

Sec. 44. *Installment Basis.*

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(b) Sales of realty and casual sales of personalty.—In the case (1) of a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year), for a price exceeding $1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed 40 per centum of the selling price, the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this section. As used in this section the term "initial payments" means the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made.

* * * * * * *

(d) Gain or loss upon disposition of installment obligations.—If an installment obligation is satisfied at other than its face value or distributed, transmitted, sold, or otherwise disposed of, gain or loss shall result to the extent of the difference between the basis of the obligation and (1) in the case of satisfaction at other than the

face value or a sale or exchange—the amount realized, or (2) in case of a distribution, transmission, or disposition otherwise than by sale or exchange—the fair market value of the obligation at the time of such distribution, transmission, or disposition. The basis of the obligation shall be the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full.

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Sec. 113. *Basis for Determining Gain or Loss.*

(a) Property acquired after February 28, 1913.—The basis for determining the gain or loss from the sale or other disposition of property acquired after February 28, 1913, shall be the cost of such property; except that—

* * * * * * *

(5) Property transmitted at death.—If personal property was acquired by specific bequest, or if real property was acquired by general or specific devise or by intestacy, the basis shall be the fair market value of the property at the time of the death of the decedent. If the property was acquired by the decedent's estate from the decedent, the basis in the hands of the estate shall be the fair market value of the property at the time of the death of the decedent. * * *

APPENDIX B.

ILLUSTRATIVE CASE.

Comparison of Taxable Profit Under Installment Basis With Profit That Could Be Taxed on Some Other Theory.

Facts:

"A" sells property in 1923 for an agreed price of $100,000.00, of which $10,000.00 is paid in cash in 1923 and the balance is represented by nine notes of $10,000.00 each, payable one in each year thereafter for nine years. The property had cost "A" $15,000.00. The purchase money notes of a face value of $90,000.00 had a fair market value of only $9,000.00 at the date of sale. "A" dies in 1927, after having collected $50,000.00 of the agreed price.

Computation of Gain Without Use of Installment Method:

Gain Realized in Year of Sale:		
Cash received in 1923	$ 10,000.00	
Fair market value of notes (10% of $90,000.00 face)	9,000.00	
Total Consideration Realized in 1923	$ 19,000.00	
Cost	15,000.00	
Gain Realized in 1923		$ 4,000.00
Gain on Collection of Notes 1924-1927:		
Amount collected on notes	$ 40,000.00	
Basis (Valuation in determining gain in 1923—10% of face)	4,000.00	
Gain on collection of notes		36,000.00
Total gain		$40,000.00

Computation of Gain on Installment Method:

Agreed Price	$100,000.00	
Cost	15,000.00	
Gross Profit to Be Realized	$ 85,000.00	
Percentage of collections representing profit	85%	
Amount collected during life of "A"	$ 50,000.00	
Profit reported on installment basis		$42,500.00